To: 'Dave Garff'[david.garff@accuvest.com]
From: Ofer Abarbanel (Institutional Secured Credit LLC)[ofer-inv@contact-inv.com]
Sent: Fri 12/20/2019 11:07:37 PM (UTC)
Subject: RE: What are your thoughts on the following

Hi Dave,

As stated in this article, the problems with the bear sterns funds were:

a. They were leveraged
b. Their collateral redemption was not guaranteed by the government since it was not issued by the government, their collateral was
Asset Backed Securities ("ABS") which may have a good credit rating but its cash flow is not guaranteed by the government but rather its only cash flows of mortgages, credit cards and auto loans

this article **further supports my view** that the we should stay with our simple and US Treasury only activity since:

1. We are NOT leveraged (as bear sterns were)

2. We limit our collateral to only plain US Treasuries with maturity of up to 2 Years since even if US Treasuries drop in value to zero and never recover back to their normal price, **their redemption is GURANTEED by the US Government back to**
full value of $100 per US Treasury thus, the investor loses only time waiting for the full redemption of up to 2 years until the collateral matures and paid by the US Government and this way the investor doesn't lose money.

Best regards,
Ofer

From: Dave Garff [mailto:david.garff@accuvest.com]

Sent: Friday, December 20, 2019 6:23 AM
To: Ofer Abarbanel (ofer-inv@contact-inv.com) <ofer-inv@contact-inv.com>
Subject: What are your thoughts on the following

From a friend of mine. What do you think about their conclusion that essentially the market is not really operating properly?

"It hasn't proven to be temporary. It hasn't proved to be reversible without massive injections of liquidity. Which means that structural issues are playing a role."

–Mohamed A. El-Erian,
Chief Economic Advisor, Allianz (on Bloomberg TV)

Let's open this week's letter with a little story, an excerpt from *All The Devils Are Here: The Hidden History of the Financial Crisis*:

"On Friday, March 2, 2007, a man named Ralph Cioffi, who ran two hedge funds at Bear Stearns that had some $20 billion invested in asset-backed securities, held a small, impromptu meeting in his office. Matt Tannin, who managed the two funds with him, was there, as was Steve Van Solkema, a young analyst who worked for the two men and another partner in the funds. They had gathered to discuss the deteriorating market conditions. The week had opened with a drop in the stock market of more than 400 points, the largest one-day decline since the aftermath of 9/11. Cioffi described February as "the most treacherous month ever in the market." They talked about the plunge in value of the riskier tranches of the ABX index. Even some of the triple-A—the triple- A—were showing a strange wobbliness. That wasn't supposed to happen—ever. The men were anxious.

*On paper, their two hedge funds hadn't performed that badly: one fund was down a little; the other was up a little. But it had suddenly become difficult to obtain prices on the securities they owned, so they couldn't be sure what their funds were truly worth. Plus, they'd often told investors that the funds operated like a boring, old-fashioned bank—they were supposed to earn the difference between their cost of funds (**a good chunk of which were provided through the repo market**) and the yield on the super-safe, mostly triple- and double-A-rated securities that they owned. Investors expected fairly steady, low-risk returns. Any losses, no matter how small, could spook them. The Bear team had made money on short positions they had placed on the ABX, but the volatility was worrisome. Because the higher-rated securities were supposed to be nearly riskless, the Bear Stearns hedge funds were highly leveraged: only about $1.6 billion of the $20 billion was equity. The rest was borrowed. Earlier in February, they'd started to get margin calls, meaning that their lenders were demanding more collateral. They'd met the margin calls, but their fears had not abated.*

*Trying to calm the others, Cioffi told them about the time he and Warren Spector, Bear's co-president, with whom Cioffi had risen through the ranks, had been caught with a big bond position way back when. They didn't panic, and they ended up making a lot of money. Tannin commiserated with Van Solkema about how the stress made it hard to get any sleep. For Van Solkema, it was comforting to hear that even the "big senior guys," as he later called them, weren't sleeping, either. **And then Cioffi opened a small fridge in his office and took out a very good bottle of vodka. They all did a shot out of paper cups, toasting to better times ahead.***

Within six months, both funds were bankrupt. A terrible storm was gathering."

I vividly remember the sub-prime crisis. My team and I were pitched on the Bear Stearns hedge funds in 2006. At the same time, my dear friend, Mark Finn, brought me up to speed on the growing sub-prime problem. The size of the leverage was daunting. We passed. I thought the sub-prime mess, with its layers of sliced and diced tranches of debt structures, would shake out badly. I had no idea it would nearly bring down the global financial system.

So when I look at this repo problem, which I don't fully have my head around, I can't help but think it may be a Bear Stearns hedge fund-like crack in the dam—an early warning. For now the Fed has its finger plugging the leak, but they are finding that it's not a real fix.

I reached out to some of the smartest people I know (friends from our annual fishing getaway at Camp Kotok in Maine) to get their thinking. I'm sharing some of their insights along with my own today. Essentially, the funding markets are broken.

It's time to hold on tight. But that doesn't mean you should go to a place of worry. Instead, go to a place of awareness. As risk grows, make sure you dial in your risk management processes just a bit more. Keep this in mind as you take in the news. The good news for now is that the bulk of overall market trend evidence continues to lean bullish. When the evidence turns, turn with it. Stay nimble… yet mindful that something foul is afoot.

Repo Madness

A very good friend called me and asked if I could explain the ongoing repo situation to him. Admittedly, I too have been a bit confused, just as I was when I first learned about sub-prime. How big is the problem? What's its source? Is the problem what it seems to be, or is something far larger brewing? Is it a consequence of the Fed letting their account balance roll off? Is it due to regulations? Is something happening offshore? Is it a non-event? I believe it is an issue we must keep on our radar, so I'm going to try to explain some of it here.

Let's start with a definition. "Repo" is short for repurchase agreement. A repurchase agreement is essentially a short-term loan. Imagine you are a bank and you have clients who need to make payroll, but you don't have enough cash on hand to cover the withdrawal. So you pledge a portion of your holdings (typically government securities) via a repurchase agreement with another bank. Bank B loans you the cash, you pledge your collateral, and you pay Bank B back tomorrow with interest. Bank B makes a little more money on the loan, picking up the yield on the government security and the interest you paid them.

There are all sorts of players who enter the repo market to solve various short-term needs. The big banks are the major ones and provide much of the liquidity. So why did rates spike from 2% to 10% in September? Why did the liquidity disappear? The simple answer is that there are not enough lenders willing to lend. The Fed has stepped in to put a Band-Aid on the problem, but the problem remains. They've now injected over $320 billion, and some estimate it will be over $500 billion by the month's end. That's a big Band-Aid, and there are no signs just yet that they will be able to rip it off.

Let's get a little deeper into the details of repos. Repos are typically used to raise short-term capital. It's a short-term loan; you need cash, so you pledge collateral to me and agree to pay me back tomorrow with interest. Some repos can be for 48 hours, but most are overnight. The implicit interest rate on these agreements is known as the repo rate, a proxy for the overnight risk-free rate. Repurchase agreements are generally considered safe investments since most agreements involve U.S. Treasury bonds posted as collateral. Repos are classified as a money market instrument. They are also a common tool of central bank open market operations.

Repurchase agreements can take place between a variety of parties. The Federal Reserve enters into repurchase agreements to regulate the money supply and bank reserves. Individuals normally use these agreements to finance the purchase of debt securities or other investments. Banks may use the liquidity for short-term funding needs.

The primary risk to the lender is counterparty risk, meaning that if Party 1 and Party 2 enter into an agreement and Party 2 defaults, Party 1 loses money. Party 2 may have posted collateral, but that collateral could become worthless if Party 2 goes bust, or if someone Party 2 loaned money to goes bust. Ultimately, if you lend money to your brother and he defaults, you're screwed. Even though collateral is posted, there may be unknown risks to that collateral.

In these arrangements, a clearing agent or bank conducts the transactions between the buyer and seller to protect the interests of each. It holds the securities and ensures that the seller receives cash at the onset of the agreement and that the buyer transfers funds for the benefit of the seller and delivers the securities at maturation. The primary clearing banks for tri-party repo in the United States are JPMorgan Chase and Bank of New York Mellon.

Like prime rates, repo rates are set by central banks. The repo rate system allows governments to control the money supply within economies by increasing or decreasing available funds. A decrease in repo rates encourages banks to sell securities back to the government in return for cash. This increases the money supply available to the general economy. Conversely, by increasing repo rates, central banks can effectively decrease the money supply by discouraging banks from reselling these securities.

Well, something is wrong. The patient is bleeding. The doctor keeps applying more dressing, but the situation hasn't improved.

From Bloomberg's Liz McCormick on December 8, 2019:

- *Reserves -- or cash that banks stash at the Fed -- are the easiest asset for banks to tap when they want to quickly move money into repo. And it would've been logical for banks to pour cash into repo to get those 10% returns from an overnight loan.*
- *The four banks that dominate the market hold about 25% of the reserves in the U.S. banking system, but 50% of the Treasuries. That mismatch likely slowed the movement of cash into repo, the BIS researchers postulated.*
- *JPMorgan Chase & Co. Chief Executive Officer Jamie Dimon has put the blame on regulators themselves. He said in October that his firm had the cash and willingness to calm short-term funding markets but liquidity rules for banks held it back.*
- *Some analysts have also pointed to a new corner of the market, which has seen immense growth: sponsored repo. This allows banks to transact with counterparties like money-market funds without impacting their balance*

sheet constraints. The downside is that it's only available on an overnight basis, and as a result has further concentrated funding risk.

- *Not only did the spike in the repo rate come as a surprise to the New York Fed, but they also haven't been able to normalize it as quickly as they thought they could.*
- *Bloomberg Opinion columnist and chief economic adviser at Allianz SE Mohamed A. El-Erian said Monday on Bloomberg TV,* ***"It hasn't proven to be temporary. It hasn't proved to be reversible without massive injections of liquidity. Which means that structural issues are playing a role."***

"Temporary" keeps extending! The following chart shows the Fed has provided $322 billion in liquidity support to the repo market since the crisis first spiked in September.

Just what are structural issues? This from fishing friend David Bianco:

"In its simplest form, the repo market is a collateralized loan. Post securities (mainly government securities) and get money. Even though the loan is collateralized, no one wants to be stuck with a default. So these loans have a credit component where premiums or over-collateralizations are required by some borrowers or others. This is not always important, but it is when markets get volatile and liquidity issues arise. The Fed views all banks as equal. Everyone that is a designated primary dealer can get the same terms, no questions asked. For now, this is not a problem. The repo market has been medicated into submission by the Fed's support. But the longer the Fed goes this way, the greater it becomes a potential problem. After three months, the Fed should be discussing a way to return this market back to normal, back to the banks making a credit decision in handing out repo loans. Instead, they are still studying the issue, which means they still don't understand the problem. They are also getting in deeper and deeper as the private sector seems to be withdrawing.

This market is too important to remain in this state. None of this is a problem now, but should Fed support become more permanent, there will be issues the next time the market undergoes a stressful period. Jim concludes*, "The repo market is under control as long as the Fed controls it."*

But can they control it? The BIS noted the European repo market escaped the crisis, but added that it has become fragmented and poses a long-term risk. When banks no longer trust banks, they position to protect what they've got. It's not the lion we see that might get us. It's the three hiding in the bushes, away from our view.

The bigger picture concerns me: The central banks may be losing control of the economy with their ability to manipulate short-term rates. Rates sit near zero percent and $12 trillion is yielding less than zero in much of the developed world. That number is down from $17 trillion. Near or at zero, nonetheless. And what time bomb may be triggered if rates spike higher? Can the central banks control the economy? A lot of the time, yes. All of the time, no. We sit late stage in one of the greatest central bank experiments of all time. This is now a question of confidence. As Martin Armstrong said in a recent blog, "The biggest danger we face is waking up to the realization that central banks can no longer control the economy. Once that is understood in the market place, the fun and games will begin."

This is not Quantitative Easing like what we got in QEs 1, 2 and 3. This Fed intervention has zero impact economically, though you could argue that it does, as it is supporting short-term liquidity needs to keep the repo market functioning. I believe this may really be about the Fed trying to prevent short-term rates from rising. If they fail to do that, the issue may spill over into other markets. That would be bad news in a world awash in debt—much of it short-term. If that debt rolls over at higher interest rates, it stresses already stressed government budgets.

I'm not sure we know all of the issues behind the repo crisis, just like I underestimated the size and global scope of the sub-prime issue when it first surfaced. I can tell you my smart friends are battening down the hatches. Keep stepping forward, but do turn your lights on. The party rolls on for now, but have your stop-loss exit triggers firmly in place. Another storm is brewing.

The Greatest Trade Ever is a book about how one hedge fund manager made billions shorting the sub-prime market. Debt is far larger than at the start of the last crisis, and the Fed has almost no room to fight the battle with interest rates. It's Ray Dalio's "pushing on a string." It will take the fiscal side of the government to bail out the next crisis and they are not really functioning well now. Speaking of Ray Dalio, he was in the news recently. He and his team put on a $1.5 billion dollar put option bet that expires in March 2020, according to reports. If the market declines meaningfully, the option makes a lot of money. If the market stays flat or moves higher between now and then, his firm loses. When you are running $150+ billion, that's a relatively small play. It may be more of a hedge vs. directional bet. But it's a significant move any way you look at it. Noted!

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